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TPF&C UPDATE

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IRS INTEGRATION RULE CHANGES WILL AFFECT MOST OFFSET PLANS

The IRS has amended its rules for integrating qualified plans with social security to reflect the gradually increasing age at which unreduced social security benefits will begin. These changes, announced in Rev. Rul. 86-74, will require the amendment of virtually all offset integrated pension plans.

The Social Security Amendments Act of 1983 raised the age at which unreduced social security benefits are payable for individuals born after January 1, 1938. The new retirement ages increase by two-month intervals, with a plateau at age 66 for those born between 1943 and 1954, reaching age 67 for those born after January 1, 1960. Rev. Rul. 86-74 states that for integration purposes, an offset plan must treat a retirement age earlier than these ages as an early retirement and reduce the maximum offset accordingly. The ruling is effective for existing plans for plan years beginning after December 31, 1986, and is effective for new plans on May 27, 1986. The ruling does not apply to excess plans.

New Integration Limits

Current integration rules (Rev. Rul. 71-446) require two adjustments for termination prior to age 65:

- one to determine the amount of the accrued social security benefit used to establish the maximum offset to the plan's accrued benefit, and
- another to adjust for early commencement of benefits.

At present, the first adjustment can be made in one of two ways. One method is to calculate the projected social security benefit by assuming zero earnings after severance until age 65. The other is to project constant current earnings to age 65 and multiply the resulting social security benefit by the ratio of actual service to service that would have been earned at age 65. Both approaches will continue to be permitted under Rev. Rul. 86-74, with the new social security retirement age substituted for age 65.

Two additional alternatives will also be available under the new ruling. Employers can (1) assume earnings to be zero through age 65 and use benefits that are payable at 65, or (2) project earnings to 65 (even if the social security retirement age is higher) and adjust the resulting social security benefit commencing at 65 by a service prorate through age 65.

The second adjustment reduces the maximum offset percentage when benefits commence before age 65. Currently, the maximum offset permitted at age 65 is reduced by 1/15 for each of the first five years and 1/30 for each of the next five years that retirement precedes age 65. Under the new revenue ruling, these factors are to be applied to the ten years of retirement preceding the new social security retirement age. This will reduce the number of years in which the 1/15 factor can be used before age 65 in cases where the normal retirement age remains 65.

Administrative Problems

Although the new social security retirement ages affect only younger employees who are still many years from retirement, deferred vested benefits must be calculated in accordance with the new rules. Rev. Ruling 86-74 does not specifically address the issue of constructing or estimating projected social security benefits. But employers that complied with Rev. Rul. 84-45, which required that the methodology for estimating social security benefits be set forth in the plan document, may have to further amend their plans to incorporate estimation based on actual social security retirement age.

Plan Design

Rev. Rul. 86-74 will require a careful review of plan design. Employers have three options:

- Varying the social security offset percentages based upon year of social security retirement age.
- Keeping a constant offset percentage for all participants and applying it to the full social security benefit regardless of its starting age. Employers who use this approach may have to reduce the offset percentage to enable the plan to meet integration rules in a "worst case" test.
- Keeping a constant percentage for all participants but applying it to the social security benefit that would be payable at age 65.

To meet new maximum integration limits, some plans will need to reduce the offset amounts. The result will be an increase in pension costs. Plans that are now maximally integrated and provide for supported early retirement reductions may be particularly hard hit.

Implications

Because decisions must be made before 1987 plan years, employers should begin considering which route to take in plan redesign and plan administration. In addition, they should keep an eye on Congress, which has been taking a long look at the integration rules. Pending legislation could accelerate the effective date of any new integration rules or provide "transitional relief" that would allow plans to avoid amendments for the brief period before the effective date of any new statutory rules.